Economy Pushes on as Trump Approaches First 100 Days

PERSPECTIVES

Kenneth J. Taubes
Chief Investment Officer, US

Executive Summary

- The US economy may lead developed nations with over 2% growth in gross domestic product (GDP) in 2017. The benefits of Donald Trump's proposed policies of lower taxes, higher infrastructure spending and less regulation should be realized more in 2018 than in 2017. However, the impact of his trade policies may offset some of the potential benefits of his fiscal policy.
- Solid employment should continue to support consumption and the housing market. Stronger corporate profits, as well as government spending, may also contribute to growth in 2018 and beyond. Increasing global Purchasing Manager Indices (PMIs) suggest that growth in global economies is also increasing.
- We believe inflation has essentially reached the Federal Reserve's (Fed's) targets, and that the Federal Open Market Committee (FOMC) risks falling behind the curve, with the economy near full capacity and little labor market slack.
- The dollar may be largely range-bound. While it may be supported by wide yield differentials, continued divergence in central bank policies and a positive economic outlook for the US, countervailing forces, including Trump's preference for a lower dollar, combined with the three openings on the FOMC, the potential for more expensive trade and the improving global economy, may put a brake on dollar appreciation.
- The market has priced in a good deal of the Trump reform platform of lower taxes, less regulation and higher infrastructure spending, which may lead to near-term disappointment if follow-through does not happen this year.

US Economic Outlook

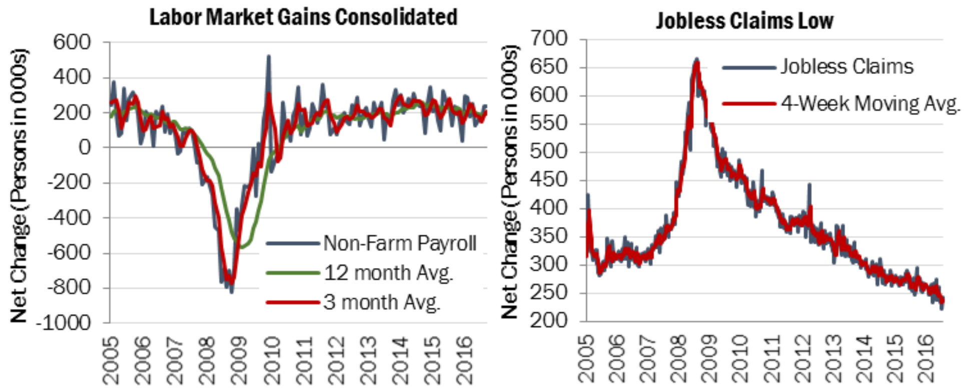
US GDP Growth: Solid, with Potential to Improve

The US may deliver growth of around 2%, as well as modestly higher inflation in 2017. Given Trump's current focus on keeping campaign promises regarding healthcare, immigration and trade, his broader pro-growth policies of tax reform and infrastructure spending may not have an impact on growth until late 2017, and in 2018. However, the Trump administration has already begun to implement stimulus through executive orders, rolling back regulations and supporting investment.

In the meantime, we believe the US should enjoy continued solid growth, driven by strong employment and consumption. Real final sales to domestic purchasers in the fourth quarter rose at a 2.8% pace, benefiting from a solid 3.5% in consumption. Strong employment growth and multi-year highs in consumer confidence may continue to support consumption.

Strong levels of employment growth and consumer confidence may support consumption.

Strong Employment Data Should Support Growth

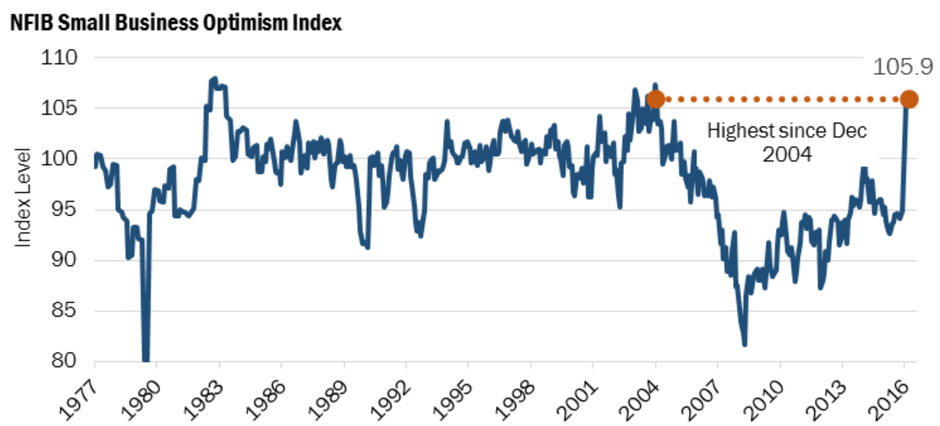


Source: Bloomberg. Last data point 2/28/17.

Small Business Optimism

In addition, small business, which accounts for an estimated 50% of US jobs, may bolster employment growth. Encouraged by the potential for tax and regulatory reform, small business indicated increased optimism subsequent to Trump's election. Optimism rose to a 12-year high and hiring plans stood at 10-year highs as well.

Small Business Optimism Has Risen to 12-Year High



Source: Bloomberg. Last data point 2/28/17.

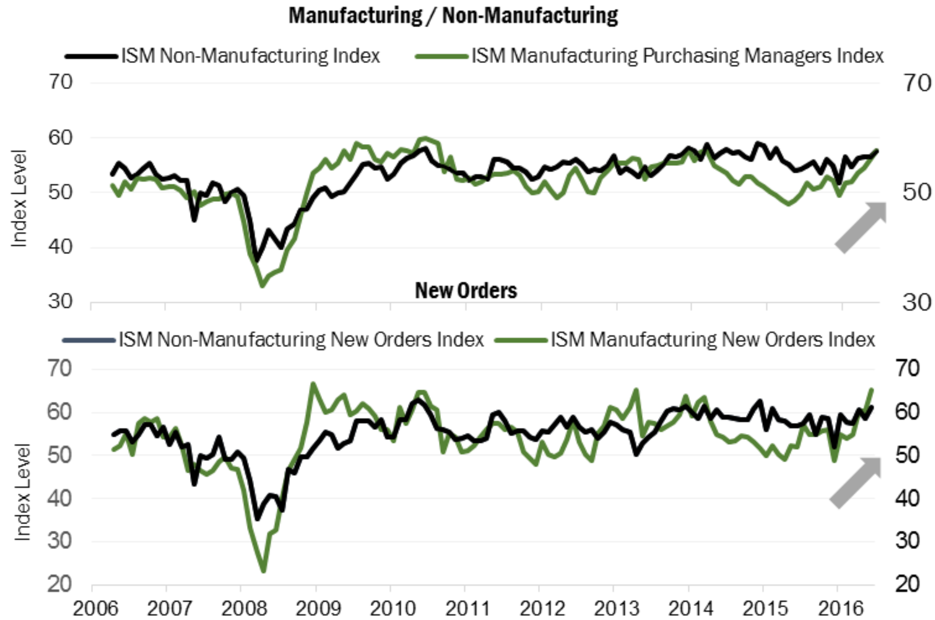
Consumption will drive growth, but business investment will also contribute.

Consumption will Drive Growth

Consistent with high confidence, consumer borrowing has increased, the savings rate has declined, retail sales have risen and auto and home sales continue to be strong.

While we anticipate that consumption will continue to drive US growth, business fixed investment may again become a contributor, after detracting from growth in 2016. Solid US growth, rising energy prices and improving global GDP growth may account for increased manufacturing demand. Despite a stronger dollar, regional surveys and the Institute of Supply Management (ISM) Manufacturing Index have enjoyed solid recoveries over the past year, as the ISM Manufacturing Purchasing Managers Index recovered from a low of 48 in December, 2015 to a two-year high of 58, with both new orders and production advancing strongly.

Manufacturing Indices Still Signaling Growth



Source: Bloomberg. Last data point 2/28/17.

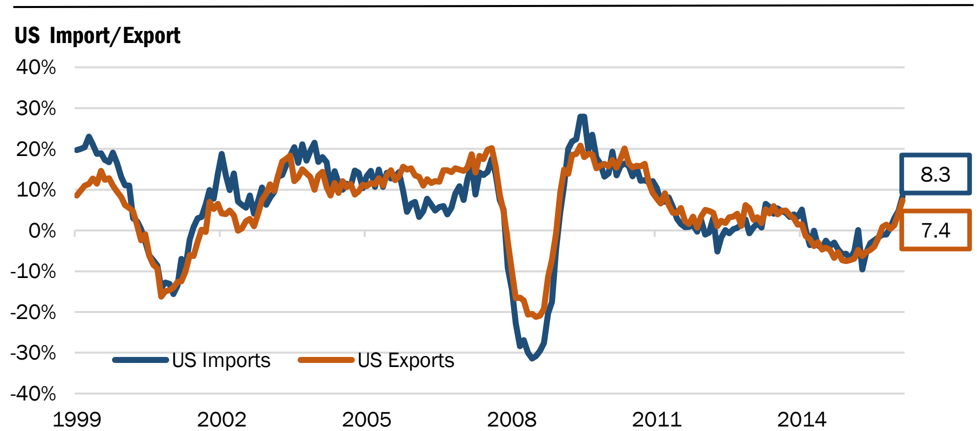
The capital-intensive energy sector may have a particularly strong impact on fixed investment, benefiting from Trump's action to put the XL and Dakota pipelines back on track, as well as output agreements from producing nations remaining supportive of prices. Oil rig counts have almost doubled from their May lows of 316 to their current level of 662 (3/30/17). With energy industry advocate Scott Pruitt now heading the Environmental Protection Agency (EPA), the industry may further benefit from reduced regulation.

Despite a modestly higher dollar, US exports have risen from their early 2016 lows.

Improving Global Growth

Rising global Purchasing Manager Indexes (PMIs) also suggest improving global trade. Despite a modestly higher dollar, US exports have risen from their early 2016 lows. Whether exports will continue to grow depends on the path of the dollar and Trump's trade policies.

Exports Up from Early 2016 Lows



Quarterly percent change from a year ago. Source: Bureau of Economic Analysis. Last data point 1/31/17.

We believe inflation is rising more quickly than many appreciate, and that the FOMC risks falling behind the curve.

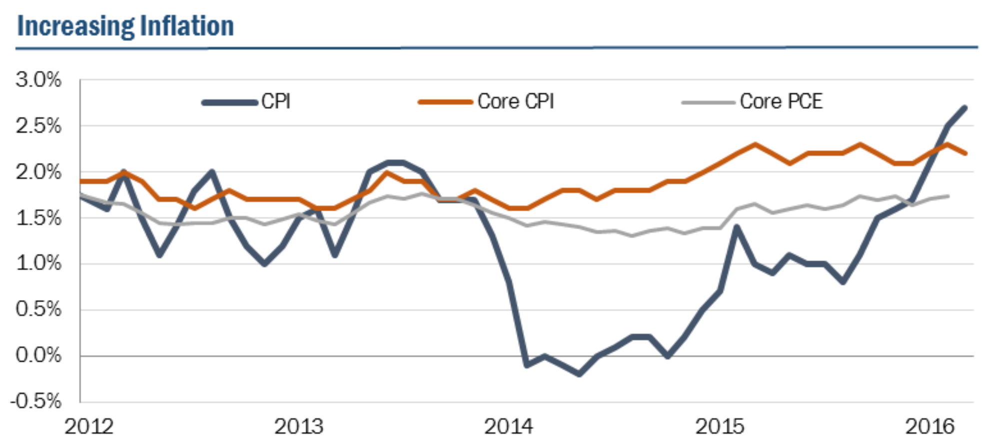
Government spending may contribute at the approximate 1% level achieved in 2016. Only in 2018 should spending rise to 1.5%, benefiting from Trump's infrastructure program, which is currently proposed at $1 trillion over 10 years.

Tax Reform will have Greatest Impact on 2018 Growth

We believe Trump's pro-growth policies of tax reform, infrastructure spending and lower regulation will have a greater effect in 2018 than 2017. Undoubtedly, the most important policy will be corporate and individual tax reform. While the Tax Policy Center estimates a 10-year, $6.1 trillion impact from tax cuts, including $2.6 trillion from corporate and $3.5 trillion from personal tax cuts[1], the House Republican Party version reflects a more modest $2 trillion impact, in recognition of concerns about the rising US deficit and US debt. For personal taxes, Trump plans to cut tax rates to 12%, 25% and 33%, limit deductions, reduce the capital gains and dividend tax rates and eliminate the estate tax and alternative minimum tax (AMT). The corporate tax rate would be cut from 35% to 15% (the House version is at 20%), capital expenditures would be immediately deductible, and offshore cash might be repatriated at 10% and interest deductibility of debt would end. While Republicans in the House have proposed a border adjustable tax, in which imports are taxed at 25%, while exports are tax-free, the proposed policy has caused significant controversy and resistance from the US retail industry, who would be largely impacted from tax on imports.

Modestly Higher Inflation

We believe inflation is rising more quickly than many appreciate, and that the FOMC risks falling behind the curve. Inflation, including wage inflation, is trending upward in an environment with little labor market slack.



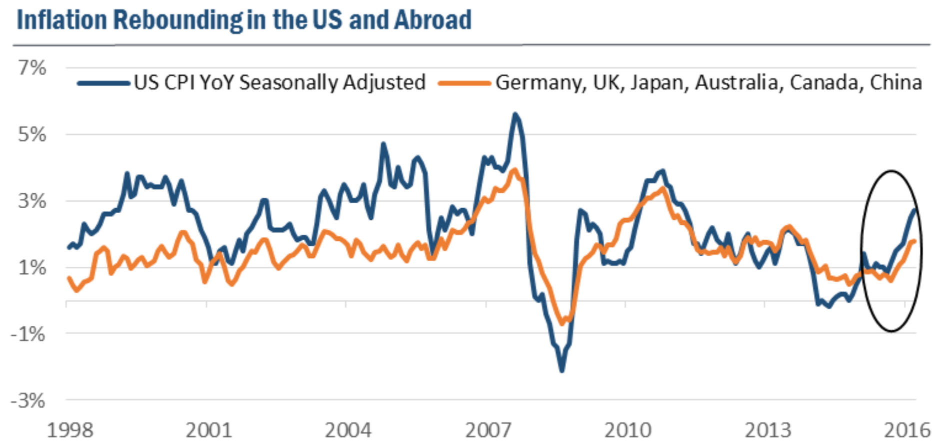
Source: Year-over-year monthly percent change. Bloomberg. Last data point 2/28/17.

Driven by a doubling of oil prices, headline Consumer Price Index (CPI) has risen over the past year from 1% to its current 2.7% level. The major components of shelter and healthcare have risen even more at 3.5% and 3.4%, respectively. Personal consumption expenditures (PCE), the preferred inflation measure of the Fed, has risen to 2.1% year-over-year through February, up from 1.6% in December. Prices have not only risen on the consumer side; on the industrial side, the Producer Price Index (PPI) increased 3.7% year-over-year in February, versus negative 2.0% year-over-year in February of 2016.

1. Donald Trump's Revised Tax Plan: Impact on Tax Revenue, 2016-26 by Fiscal Year and Total for FY2027-36 (Updated, November 14, 2016)

Inflationary Pressures Reflected Globally

These inflationary pressures are echoed globally. Global inflation, reflecting higher energy prices and depreciating currencies relative to the dollar, is rising along with US inflation.



Source: Bloomberg. Data as of 2/28/17 except Japan and Canada, which are as of 1/31/17.

A more positive economic outlook and rising inflation may lead to more hawkish Fed policies.

Trends in wage inflation, a key inflation measure for the Fed, continue to underperform expectations. Although unemployment has fallen to 4.7%, meeting the Fed's definition of full employment, wage inflation has remained subdued relative to past recoveries. We believe that wage inflation may be poised to increase markedly in 2017, should monthly payroll gains continue to exceed trend labor force growth, and the unemployment rate fall to 4.5% by year-end. Bianco Research has projected that average hourly earnings could reach 3.5% by January of 2018, based on its model that incorporates NFIB wage data, labor slack, manufacturing growth and consumer sentiment.

With economic and inflation data having generally surprised to the upside recently, the Federal Reserve Board has recently announced its first of three projected rate increases for 2017.

A Range-bound Dollar

A more positive economic outlook and rising inflation may lead to more hawkish Fed policies, which may support the dollar. Even though Trump's tax reform and fiscal stimulus may not contribute to US growth until 2018, their projected benefits may also be dollar-positive. Furthermore, increased political risk in Europe, with the potential for populist victories in upcoming elections in France and Italy and continuing capital outflows from China, in the wake of declining growth and a weaker yuan, may help the dollar.

However, it seems more likely that the dollar will trade in a range due to offsetting factors, including the potential for tighter global central monetary policy, and the possible negative impact of Trump's trade policies. Other central banks may choose to reduce quantitative easing in light of higher global growth and inflation. In addition, Trump appears to believe that the US dollar is overvalued, having complained about the US trade deficit and that major trade partners – such as Mexico, Germany, Japan and China – have unfairly depreciated their currencies to gain trade advantage. While proponents of the border-adjustment tax believe that any negative impact on US importers will be offset by a higher dollar, others believe that Trump's trade policies can invite retaliation and may ultimately hurt the status of the dollar. Finally, the proposed tax repatriation involving more than $1 trillion of cash held offshore may have muted effects on the dollar, since it is believed most of that cash is already held in, or hedged to, dollars.

We continue to believe credit sectors offer modest value compared to government securities.

Market Outlook

We continue to believe credit sectors offer modest value compared to government securities. Although global yields have risen from their July lows, many short-term non-US developed market sovereign debt continues to trade at negative nominal yields, and 10-year bonds offer zero to modest positive yields. US Treasuries continue to offer negative or modest real yields, adjusted for CPI inflation.

We hold a neutral view with respect to the agency mortgage-backed securities (MBS) sector. While we believe housing fundamentals remain strong, the Fed's significant ownership of the asset class presents increased risk. Strong employment should continue to support the housing market. Although housing affordability has declined with rising rates and higher home prices, the index indicates steady levels of affordability.

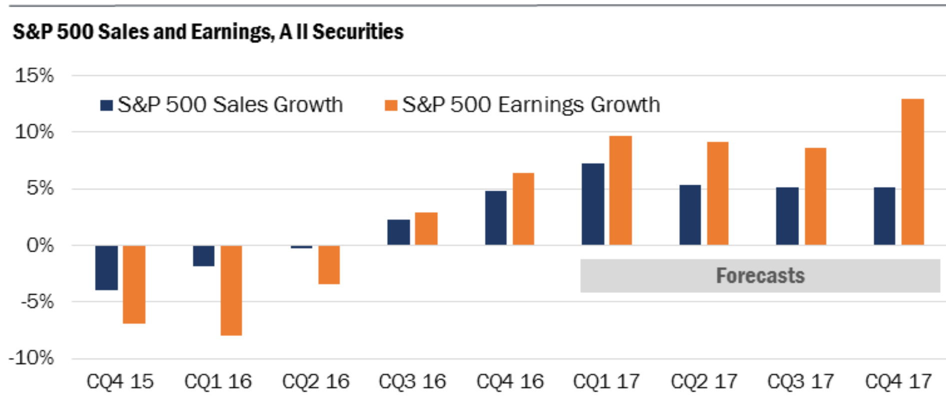
Housing Affordability Has Declined, but Remains Strong

Source: Federal Reserve. Last data point 1/1/17.

However, Fed Chairman Yellen recently confirmed that the FOMC has begun to discuss winding down the Fed's balance sheet, and some believe such action might occur in late 2017 or in 2018. With the Fed owning 20% of outstanding agency MBS, any decision to stop reinvestment of coupons or paydowns could have a significant negative impact on the market.

We believe corporate credit offers moderate value, based on improving profits and the potential for tax reform. Profit and revenue growth turned positive in the third quarter of 2016 and should enjoy strong performance in 2017.

Both Earnings and Sales have Started to Grow



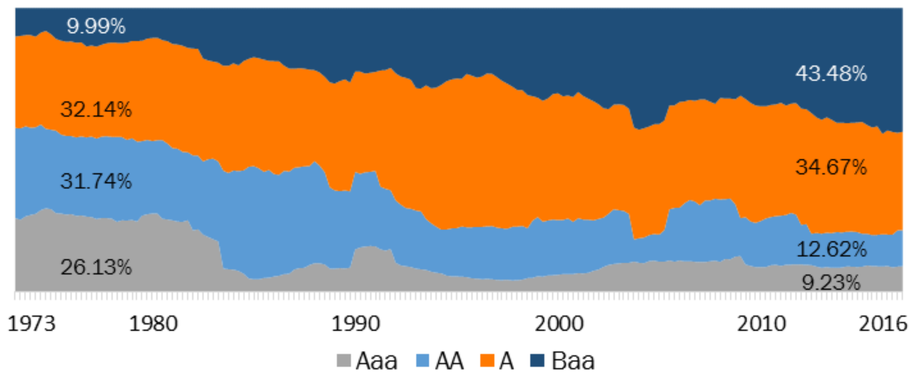
Earnings Season for 4th Quarter 2016 ended 2/15/17. Source: Bloomberg.

However, we have become more cautious on corporates in the past year, as spread levels have declined well below long-term averages and leverage has risen. The deterioration in credit quality is most pronounced in the investment-grade market, as is evident from the following chart. Corporations have financed share buybacks and increased dividends through issuance of debt at record low yields.

The deterioration in credit quality is most pronounced in the investment-grade market.

Credit Quality Decline Most Evident in Investment Grade Market

Quality of the Bloomberg Barclays Credit Index 1973-2016



Source: Barclays. Last data point 12/31/16.

Relative to high yield, we believe that bank loans offer value. BB and B yield-to-maturities are only modestly lower than the corresponding bond yields in the high yield market, but without the duration risk. Investors should remain cognizant of repricing risk in loans, given that most loans carry minimal call protection and are pre-payable at any time.

The potential for corporate tax cuts and cash repatriation under the Trump administration has provided a tail wind for equities following Trump's election.

Impact of Tax Reform on Corporate Credit

The potential for corporate tax cuts and cash repatriation under the Trump administration has provided a tail wind for equities following Trump's election. The impact on corporate credit is more nuanced.

Tax Cuts

Proposed corporate tax cuts from 35% to 15% or 20%, could have a beneficial impact on corporate earnings, benefiting both debt and equity holders. Corporations with high effective tax rates, that conduct business primarily in the US, and that have minimal net operating losses and deferred taxes, would stand to benefit the most.

However, tax cuts and the potential elimination of interest deductibility would effectively increase the cost of debt financing, which could result in lower debt issuance going forward. Deductibility of existing debt may be grandfathered, while only newly issued debt would be subject to the new rule. As a partial offset to interest deductibility, Trump has proposed the expensing of capital investment for manufacturers, which may provide an incentive for further capital investment in the US.

Repatriation

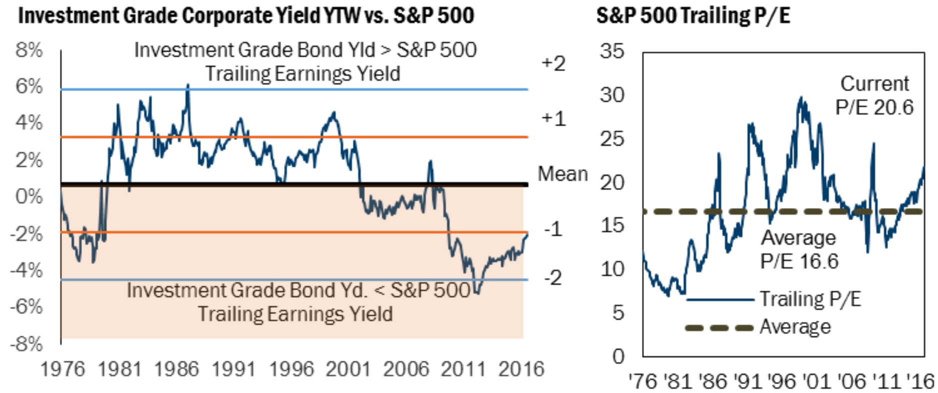
There may be over $1 trillion of offshore cash held by approximately 30 to 40 multinational corporations, focused in technology and pharmaceuticals, many with payout ratios exceeding 100%. The proposal to repatriate these earnings at a 10% rate or less could deliver that net cash for use in the US, as well as $300 billion of additional value for non-financial firms. To the extent that repatriated earnings are used for share buybacks or increased dividends, this decision could result in significant leverage increases and downgrades among certain corporate issuers.

We believe US equities should be favored over fixed income, as valuations are relatively better.

Equities

We believe US equities should be favored over fixed income, as valuations are relatively better. US earnings growth, while limited, is improving. However, after the strong performance of US equities over the last five years, absolute valuations are becoming higher, while international equity is starting to become more attractive.

Stocks vs. Bonds Valuation — Stocks More Attractive



Source: Bloomberg. Last data point 2/28/17.

At this stage of the economic cycle, we expect market volatility to increase. The US equity market has priced in a lot of good news, including the benefits of legislation yet to be passed. While cyclical stocks have recently surged on the prospects of higher growth, we believe that high-quality stocks should perform better if monetary policy tightens at a quicker pace, or if growth trends weaken. Two of last year's lagging sectors, the consumer and healthcare sectors, may be poised for improved performance in 2017 due to their resilience in earnings growth throughout economic cycles and continued innovation and pricing power.

We also favor technology and financials. Technology may benefit from the shift to mobile and cloud computing, while financials should benefit from rising rates. Cyclical industries and sectors such as financials, basic materials and industrials could perform better. However, there have already been strong moves in these sectors ahead of any actual improvement in fundamentals. We are taking a cautious stance and focusing on more predictable and stable companies in consumer staples and healthcare.

Growth stocks typically outperform late in an economic cycle. Given the underperformance of growth stocks last year, valuations are also now attractive, trading at only a modest premium to value stocks.

Important Information

Yield-to-worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

Trailing PE (price/earnings) is the sum of a company's price-to-earnings, calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months.

Date of First Use: **April 4, 2017**.

30081-00-0417